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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 215

BERNARD REALTY COMPANY, PETITIONER

v.

THE UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 46-54) is reported at 92 F. Supp. 805. The opinion of the Court of Appeals (R. 71-75) is reported at 188 F. 2d 861.

JURISDICTION

The judgments of the Court of Appeals were entered on May 7, 1951 (R. 76-77). The petition for a writ of certiorari was filed on July 31, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the purchase price payable by taxpayer as the vendee under a Wisconsin land contract constituted an indebtedness evidenced by a note or mortgage and thus was "borrowed invested capital" within the meaning of Section 719 of the Internal Revenue Code for the purpose of computing taxpayer's excess profits credit by the invested capital method.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 719 [As added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, and amended by Section 230(b)(2) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. BORROWED INVESTED CAPITAL.
>
> (a) *Borrowed Capital.*—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:
>
> (1) The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, * * *.
>
> * * * * *
>
> (b) *Borrowed Invested Capital.*—The borrowed invested capital for any day of any taxable year shall be * * * an amount equal

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to 50 per centum of the borrowed capital for such day.

(26 U.S.C. 1946 ed., Sec. 719.)

STATEMENT

The material facts are stipulated (R. 11-19), and were incorporated as stipulated in the District Court's opinion (R. 46-49). They may be summarized as follows:

The petitioner, hereinafter called the "taxpayer", is a Wisconsin corporation engaged in the business of owning, operating and dealing in real estate. On or about April 1, 1940, it entered into a written agreement entitled "Land Contract," for the purchase of improved real estate located in the City of Milwaukee. (R. 11.) The contract recited that the property was subject to a certain mortgage, which the vendor agreed it would cause to be satisfied on or before full performance of taxpayer's obligations under the agreement. Taxpayer agreed to pay the vendor a purchase price of $325,000, payable $50,000 down, $1,458.33 monthly, for the period from April of 1943 to March of 1950, and the balance of $152,500 on or before March 31, 1950. In addition, taxpayer agreed to pay to the vendor amounts sufficient to cover all taxes and assessments against the property, to keep the premises insured in designated amounts against fire and other perils, and to maintain the premises in good repair and

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condition. In the event of taxpayer's failure to perform any of its obligations under the contract, the vendor, at its option, had the right either to (1) cancel and terminate the contract, resume possession of the premises, and retain as liquidated damages all amounts theretofore paid by taxpayer; or (2) accelerate payment of the balance of the purchase price remaining unpaid. Upon full performance by taxpayer, the vendor was by warranty deed to convey title to taxpayer free and clear of all liens. (R. 14-19.)

Pursuant to the terms of the contract, taxpayer made various payments to the vendor. The balance of the purchase price due as of the end of 1942 amounted to $265,000, and the average daily balance due during 1943 was $259,038.83. The balance due as of the end of 1943 was $250,-416.70, and the average daily balance due during 1944 was $241,913.43. (R. 11-12.)

In its excess profits tax returns for 1943 and 1944, taxpayer took a credit based on invested capital, and in computing its invested capital it included as "borrowed invested capital", under Section 719 of the Internal Revenue Code, 50 per cent of the average daily balance of the price due under the land contract. The Commissioner determined that the amounts due did not represent "borrowed capital" within the meaning of Section 719 (a)(1), and determined deficiencies in tax accordingly. Taxpayer paid the deficiencies,

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and thereafter filed claims and instituted suits for refund. (R. 12-14.)

The District Court granted judgment for taxpayer, holding that the purchase price payable by taxpayer under the land contract represented an "outstanding indebtedness * * * evidenced by a * * * mortgage * * * *" within the meaning of Section 719 (a)(1) and was therefore includible in taxpayer's borrowed invested capital for purposes of computing its excess profits credit (R. 49-54, 62). The Court of Appeals reversed, holding that the purchase price payable under the land contract was not an indebtedness evidenced by either a note or a mortgage (R. 73-75).

ARGUMENT

Taxpayer has asserted no adequate ground for granting the writ.

1. The decision below is not in conflict with the decision of the Court of Appeals for the Second Circuit in *Brewster Shirt Corp.* v. *Commissioner,* 159 F. 2d 227. Taxpayer's assertion to the contrary appears to be premised upon a statement (Pet. 7) that the *Brewster* decision held that borrowed invested capital within the meaning of Section 719 of the Internal Revenue Code (*supra,* p. 2) consists of an indebtedness evidenced by almost any written instrument so long as it definitely creates an obligation. The *Brewster* decision did not so hold. In that case, the taxpayer had assigned accounts receivable to a factor as security

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for a loan and, under the factoring agreement, became unconditionally indebted to the factor. The Second Circuit held that the indebtedness of the taxpayer was covered by Section 719 as being an indebtedness "evidenced by a * * * mortgage, * * *." The holding was based on statements that what is legally a mortgage is a matter of substance, not of mere form (p. 229), and that the factoring agreement and assignment together "constituted" a mortgage of the accounts receivable to secure the taxpayer's indebtedness to the factor (p. 230). Cf. the same court's decision in *Frankel & Smith Beauty Dept.* v. *Commissioner,* 167 F. 2d 94. In the present case, the court below held that taxpayer's obligation under the land contract was not an indebtedness covered by Section 719 as being an indebtedness evidenced by either a note or a mortgage. The holding was based upon the conclusion that the land contract was not in legal substance a note, since it was bilateral in legal effect rather than a unilateral promise to pay a fixed sum at a specified time (R. 74-75), and on the further conclusion that the land contract in legal substance was more in the nature of a conditional sales contract than a mortgage (R. 75). Thus, both the decision below and the *Brewster* decision turned on the legal substance of the instruments involved and the difference in result in the two cases was occasioned simply by the difference in the instruments involved.

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2. The case does not involve an important question requiring decision by this Court. The decision below, holding that a Wisconsin land contract does not satisfy the requirements of Section 719, is in accord with the decision of the Tenth Circuit in *Consolidated Goldacres Co.* v. *Commissioner,* 165 F. 2d 542, certiorari denied, 334 U. S. 820, dealing with conditional sales contracts. Also compare, *Canister Co.* v. *Commissioner,* 164 F. 2d 579 (C.A. 3d), certiorari denied, 333 U. S. 874; *Frankel & Smith Beauty Dept.* v. *Commissioner,* 167 F. 2d 94 (C.A. 2d). No occasion for review of the case is presented by the fact that the new excess profits tax statutes enacted this year include a section comparable to Section 719 of the old excess profits statutes, which were repealed in 1945. The same question as is here presented will not arise under the new statute, Section 439 (b)(1) of the Code (Pet. Appendix-1), for that statute specifically covers indebtednesses evidenced by conditional sales contracts. The inclusion of such indebtednesses in borrowed capital under the new statute has no bearing on an interpretation of Section 719, for the legislative purpose in the two statutes was different. As the court below stated (R. 74), the legislative history of Section 719 persuasively shows that Congress intended by that section to confine the definition of borrowed capital to

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indebtednesses evidenced by the specific instruments named in the section.

3. Review of the case by this Court is not required by the fact that the case involves a consideration of the legal substance of a Wisconsin land contract. The holding of the court below that the land contract did not constitute a note or a mortgage (R. 74-75) is clearly correct. Taxpayer's argument that the contract constituted a note (Pet. 9-12) was not accepted even by the District Court and is answered by the very case upon which taxpayer relies, *Aetna Oil Co.* v. *Glenn,* 53 F. Supp. 961 (W.D. Ky.). In that case, the court stated that a note is distinguished from the usual type of bilateral executory contract in that it is executory on one side only, with the entire consideration having been passed (p. 966). Taxpayer does not argue that the land contract constituted a mortgage and the District Court's decision, reversed on appeal, held only that the contract was the "equivalent" of a mortgage for the purposes of Section 719. (R. 53.)

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CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1951.

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